

AN OVERVIEW OF ACCOUNTANTS' DUTIES AND LIABILITIES UNDER THE FEDERAL SECURITIES LAWS AND A CLOSER LOOK AT WHISTLE-BLOWING

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The Securities and Exchange Commission's civil complaint in the *Securities and Exchange Commission v. National Student Marketing Corporation* case¹ has evoked widespread and well justified interest on the part of the two professional groups most intimately involved in the federal securities regulatory scheme: lawyers and accountants. Members of both professions are among the defendants in that suit, and as to both the Commission asserts a duty which both professions may fairly regard as without present legal foundation: a duty to blow the whistle on one's client. It is the purpose of this article to consider that asserted duty as respects public accountants—with an occasional comparative glance at the situation of lawyers.

Before addressing this novel question of accountants' responsibilities it may be appropriate to sketch in the general framework of the duties and liabilities of accountants under the federal securities laws within which the question arises. This familiar ground may most usefully be covered for present purposes under four heads: the kinds of factual situations in which questions as to accountants' duties and liabilities may arise; the kinds of liability the accountant may incur for failure to discharge his duties; the particular sources of the accountants' duties enforceable under the securities laws; and the varying degrees of exigence that characterize such duties.

I. THE FRAMEWORK

A. *The Factual Settings*

There are four principal factual situations in which questions as to accountants' duties and liabilities may arise. The first and most familiar situation, and the one giving rise to the most extensive responsibility, is that in which the accountant has issued his opinion on financial statements, following an examination in accordance with generally accepted auditing standards.² The opinion is the result and emblem of the public

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¹ See Complaint, SEC v. National Student Marketing Corp., Civ. No. 225-72, [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,360 [hereinafter referred to as NSMC].

² See AICPA, STATEMENT ON AUDITING STANDARDS NO. 1 §§ 510-561 (1973). [Hereinafter SAS 1].

accountant's most exalted role—that of independent auditor—and it is this role which the accountant is principally called upon by the federal securities laws to perform.³

The second situation is that in which the accountant is associated with unaudited financial statements which are accompanied by his disclaimer of opinion, the disclaimer serving both to acknowledge a limited degree of responsibility for the financial statements, and to make clear that he has not audited the financial statements and that he does not express an opinion as to the fair presentation of what they purport to show.⁴ Although there are numerous instances where unaudited (principally interim) financial statements are required to be filed with the Commission, or are included in documents subject to the Commission's jurisdiction,⁵ and although in many instances the accountant will have had some hand in the preparation of the unaudited financial statements, there is not, as in the case of audited financial statements, any statutory requirement for such participation.

The third situation is that in which the accountant has participated in the preparation of financial or other material for his client, but has taken no ostensible responsibility for the material by way of an opinion or disclaimer, or otherwise. Where the material so prepared is in the form of financial statements, an accountant subject to the Code of Professional Ethics of the American Institute of Certified Public Accountants [AICPA] may not properly avoid appending a disclaimer to such financial statements, together with, perforce, his name.⁶ Even accountants not members of the AICPA are in all likelihood effectively bound by this professional standard.⁷ There is nonetheless an area in which an accountant may quite properly prepare financial data other than such state-

³ See, e.g., SEC, REGULATIONS S-X, 17 C.F.R. § 210.2-02 (1973); Securities Act of 1933, Schedule A (29), 15 U.S.C. § 77aa(29) (1970); SEC Form 10-k Instructions as to financial statements, 3 CCH FED. SEC. L. REP. ¶ 31,106. [Hereinafter the Securities Act of 1933 will be referred to as the Securities Act and the Securities Exchange Act of 1934 will be referred to as the Exchange Act].

⁴ See SAS 1 § 516.01-13; Cf. *Ryan v. Kanne*, 170 N.W.2d 195 (Iowa 1969).

⁵ E.g., SEC Form S-1, Item 6, Summary of Earnings, 1 CCH FED. SEC. L. REP. ¶ 7123; SEC Form 10-Q, Item H, Presentation of Financial Information, 3 CCH FED. SEC. L. REP. ¶ 31,031.

⁶ In 1967 AICPA, STATEMENT ON AUDITING PROCEDURE NO. 38, now reflected in SAS 1 § 516.01-13, imposed these requirements and effectively abolished the previous practice of issuing "plain paper" statements. The Institute's Restated Code of Professional Ethics, effective March 1, 1973, makes compliance with such requirements an ethical imperative. See AICPA, CODE OF PROFESSIONAL ETHICS, Rule 202 (1973).

⁷ This would follow from the general rule that one who undertakes to perform professional service is bound by the standards of the profession, See RESTATEMENT (SECOND) OF TORTS § 299A (1965), and the fact that AICPA pronouncements such as the SAS are the most authoritative statements available as to the standards of the accounting profession.

ments for his client, without requiring that his name or a disclaimer be attached thereto; for example, he may make calculations or prepare tabulations from which the client may in turn draw data which are published without attribution.⁸

The final and most significant factual situation for the purposes of this paper is that in which the accountant has knowledge of actionable fault on the part of his client or of persons associated with the client, but where the fault does not relate to matters for which the accountant is actually or ostensibly responsible. Such fault may pertain to misstatements or omissions in filings or other documents, where the accountant has some responsibility for the document because it contains financial statements which the accountant has examined or prepared, but the error pertains to a portion of the document for which he has no responsibility—as, for example, material error, not related to the financial statements, in the textual portion of the prospectus. Alternatively, it may relate to misconduct, whether by omission or commission, with which the accountant has no contact beyond his mere knowledge: as, for example, a failure by the client to make a required filing, or an error or omission in a filing which contains no financial statements.

B. *Categories of Liability*

The kinds of liability to which an accountant may be subject for failure to discharge his duties under the federal securities laws may be conveniently identified in terms of the four principal kinds of proceedings in which liability may be assessed: civil damage suits, criminal proceedings, civil injunctive actions instituted by the Commission, and administrative proceedings by the Commission.

As respects civil liability, the principal statutory provisions, and indeed the only ones that really deserve serious discussion, are two: Section 11 of the Securities Act⁹ and § 10b of the Exchange Act¹⁰ and Rule 10b-5¹¹ thereunder. The former imposes the most stringent liability, in a number of respects;¹² but, alas for the plaintiffs' bar, its availability is limited to those cases where a registration statement or prospectus

⁸ See *Wessel v. Buhler*, 437 F.2d 279 (9th Cir. 1971).

⁹ 15 U.S.C. § 77k (1970).

¹⁰ 15 U.S.C. § 78j(6) (1970).

¹¹ 17 C.F.R. § 240.10b-5 (1973).

¹² The standard of liability is negligence, see text at Note 54, *infra*; the burden of proof with respect to whether the necessary care was exercised is on the defendant, § 11(b); no reliance is required unless the plaintiff purchased the securities after the registrant had made public an earnings statement covering the period of at least a year following the effective date of the registration statement, § 11(a), and the burden of proof as to lack of causation of damages is on the defendant, § 11(e).

under the 1933 Act is involved—a limitation which would be largely loosened by the American Law Institute's Draft Federal Securities Code.¹³ Rule 10b-5, on the other hand, is of broad applicability—not unlimited, to be sure,¹⁴ but nonetheless broad enough to cover virtually any situation in which a private damage claim can be laid under other provisions of the Securities Acts; but it is markedly less stringent in effect than § 11.¹⁵ This too would largely be changed by the ALI's Draft Code.¹⁶

There are a number of other provisions of the Securities Acts which are frequently invoked in suits involving accountants as defendants. In one or more respects each of them is of narrower applicability or of lesser utility to plaintiffs than the two prime provisions just discussed, and they are thus of little practical importance. These provisions are § 12(2) of the Securities Act,¹⁷ § 17(a) of the Securities Act,¹⁸ and § 18

¹³ ALI, Federal Securities Code, Tentative Draft No. 2 § 1403 (March 1973). Section 1403 of the proposed Code is an adaptation of § 11 of the Securities Act but would apply not only to the "offering statement" which is the Code's equivalent to the Securities Act registration statement, but also to the equivalents to the Exchange Act registration statements filed in connection with issuer registration and Form 10-K annual report filed with the Commission. See also, H. BLOOMENTHAL AND S. WING, SECURITIES LAW 8-278 (1973).

¹⁴ There is still a requirement that the misrepresentation be made in connection with the purchase or sale of a security, though this seems to become increasingly attenuated. See, e.g., *Eason v. General Motors Acceptance Corp.*, CCH FED. SEC. L. REP. ¶ 94,344 (7th Cir. 1973); *Mount Clemens Industries, Inc. v. Bell* [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,552 (9th Cir. 1973).

¹⁵ In addition to a higher threshold of liability, see text at Notes 55 through 58, *infra*, there are still under rule 10b-5 at least vestiges of requirements of a showing of reliance and causation, see 2 BROMBERG, SECURITIES LAW: FRAUD, §§ 8.6, 8.7; and the burden of proof as to all elements to the cause of action is at least theoretically upon the plaintiff. *Id.*, § 8.4(332), (528).

¹⁶ See H. BLOOMENTHAL AND S. WING, *supra* note 13, at 8-266.

¹⁷ 15 U.S.C. § 771(2). This section provides for liability to a purchaser of securities of one who offers or sells the securities by means of a communication which includes a material misstatement or omission. The standard of liability, as under § 11, is negligence, and the burden of proof as to that element is as with § 11 on the defendant. This section is ordinarily read to require privity between the defendant and the plaintiff, see *Barlas v. Bear, Stearns & Co.* (N.D. Ill. March 31, 1966), '64-'66 CCH DEC. ¶ 91,674, but cf. *Free v. Szabo Food Service, Inc.* (N.D. Ill. January 4, 1964) '62-'64 CCH DEC. ¶ 91,317, and so would exclude in ordinary circumstances a claim against an auditor resting purely on responsibility for financial statements. Despite this, it seems to be frequently invoked in complaints against accountants. It has been held to support a claim of aiding and abetting. In *Re Caesar's Palace Securities Litigation*, CCH FED. SEC. L. REP. ¶ 94,005 (E.D. Pa. 1973).

¹⁸ 15 U.S.C. § 77q (1970). This provision is in substance identical to rule 10b-5 under the 1934 Act, except that it is limited to offers and sales of securities, whereas the latter applies to purchases as well. For an example of its invocation in civil damage actions against accountants, see *State Mutual Assurance Co. of America v. Arthur Andersen & Co.*, (S.D.N.Y. September 10, 1971), '71-'72 CCH DEC. ¶ 93,217 (summary of complaint). The standard of liability is not spelled out in the statutory provision, but has, as with its Exchange Act twin, been generally held to require something more than ordinary negligence. See *Fischman v. Raytheon Mfg. Co.*, 188 F.2d 783 (2d Cir. 1951); *contra*, *Ellis v. Carter*, 291 F.2d 270 (9th Cir. 1961).

of the Exchange Act.¹⁹ Also occasionally invoked is § 14(e) of the Exchange Act.²⁰

Criminal liability may arise in any of the circumstances in which there would be civil liability under the provisions of the Securities Acts described in the two foregoing paragraphs, provided only that there is a showing of criminal scienter; for willful violation of any of the prohibitions of the Securities Act is punishable under § 24 of that act,²¹ and the same sanction is provided with respect to the Exchange Act by § 32.²² Although these are the applicable criminal provisions of the securities laws as such, they do not appear, as a practical matter, to be the principal statutory provisions on which federal securities prosecutions rest. The main prosecutorial implements for this purpose appear to be the mail fraud statute,²³ which by providing for a separate crime for each item placed in the United States mails, allows an almost infinite multiplication of counts; and the conspiracy statute,²⁴ the virtues of which as a prosecutor's tool are well known and need not be recounted here.²⁵ The typical pattern of prosecution in which accountants are involved is likely to include one or the other, if not both, of the discussed provisions of the Securities Act, plus a sprinkling of separate counts under the mail fraud statute, plus a conspiracy count gluing the whole together.²⁶

Injunctive actions to restrain the repetition or future commission of violations of the Securities Acts may be brought by the Commission under

¹⁹ 15 U.S.C. § 78r (1970). This section predicates liability upon filings with the SEC which contain material misstatements or omissions. The statutory language itself makes clear that the plaintiff has the burden of showing reliance and causation, and that while the burden of proof as to fault is on the defendant, the standard of care is good faith and lack of knowledge—that is, the standard of fault is fraud. For a case involving the assertion of liability against an accountant under this provision see *Fischer v. Kletz*, 266 F. Supp. 180 (S.D.N.Y. 1967).

²⁰ 15 U.S.C. § 78n (1970). This provision, like § 17 of the Securities Act and rule 10b-5 under the Exchange Act, is purely prohibitory in terms but has been construed to imply a private right of action. It prohibits, *inter alia*, material misstatements and omissions in connection with tender offers and solicitations of proxies. There do not appear to have been any reported cases in which this provision has been successfully invoked against an accountant defendant. Cf. *Richardson v. Hamilton Int'l Corp.*, CCH FED. SEC. L. REP. ¶ 94,749 (E.D. Pa. 1974).

²¹ 15 U.S.C. § 77x (1970).

²² 15 U.S.C. § 78ff (1970).

²³ 18 U.S.C. § 1014 (1970).

²⁴ 18 U.S.C. § 371 (1970).

²⁵ See, e.g., Mathews, *Criminal Prosecutions Under the Federal Securities and Related Statutes: The Nature and Development of SEC Criminal Cases*, 39 GEO. WASH. L. REV. 901, 937-938 (1971).

²⁶ See, e.g., *United States v. Simon*, 425 F.2d 796 (2d Cir. 1969), *cert denied*, 397 U.S. 1006 (1970); *Indictment, United States v. Goldblum*, Crim. No. — [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,200 (C.D. Calif. 1973) (the *Equity Funding case*); *Indictment, United States v. Clark*, Crim. No. 72-138 (S.D.N.Y.) (the *Four Seasons case*).

either § 20 of the Securities Act,²⁷ or § 21 of the Exchange Act.²⁸ As a general matter, it would seem, the utility to the Commission of an injunction restraining the repetition of a particular violation by an accountant is slight, since the chances are that the client whose financial statements were involved in the violation and the accountant would have long since parted company. Presumably for this reason the current trend in Commission enforcement actions appears to be to seek an injunction against all future violations of whichever prohibitory provisions can be invoked. Thus the defendant is enjoined to go and sin no more, the value of the injunction presumably being to make future enforcement actions easier to bring successfully.

A high proportion of the Commission's injunction actions result in relief by consent; and such relief sometimes takes special forms not so likely to be available from a court in a contested trial. Thus, in *SEC v. Rafer*,²⁹ the accountant was not only enjoined from violation of registration and anti-fraud provisions of the federal securities laws, but also required to serve copies of the court's opinion, findings, and judgment on all existing and prospective clients for the following three years, and to file an affidavit with the court and the Commission certifying his compliance with the order. In a more recent case, involving the national firm of Laventhol Krekstein Horwath & Horwath [LKH&H],³⁰ the court's decree, entered by consent, requires the defendant accounting firm to adopt an internal quality control system, to adhere to it, and to submit to an inspection by a team selected by the Commission for the purpose of determining whether its compliance is satisfactory.³¹

The final variety of proceeding which an accountant may face for dereliction of his obligations is an administrative proceeding under rule 2(e) of the Commission's Rules of Practice.³² The sanctions available under this rule are disbarment and suspension, which have been applied not only to individual practitioners, but to entire firms as well³³—even

²⁷ 15 U.S.C. § 77t (1970).

²⁸ 15 U.S.C. § 78u (1970).

²⁹ No. 70 Civ. 547 (S.D.N.Y. 1970), reported in SEC Litigation Release No. 4581 (April 3, 1970).

³⁰ *SEC v. Everest Management Corp.*, No. 71 Civ. 4932 (S.D.N.Y. 1973) discussed in SEC Accounting Series Release No. 144 (May 23, 1973).

³¹ Similar relief is apparently sought in Complaint, *SEC v. Talley Industries Inc.*, No. 73 Civ. 4603 [1973 Transfer Binder] CCH FED. SEC L. REP. § 94,198 (S.D.N.Y. 1973).

³² 17 C.F.R. § 201-2(e) (1973).

³³ See, e.g., SEC Accounting Series Release No. 78 (Mar. 25, 1957) (firm suspended for 15 days); SEC Accounting Series Release No. 73 (Oct. 10, 1952) (firm suspended for ten days); SEC Accounting Series Release No. 68 (July 5, 1949) (firm suspended for 30 days); SEC Accounting Series Release No. 59 (Jan. 23, 1947) (firm suspended for one year).

though the rule itself does not in terms refer to firms. Suspension or disbarment for an accountant or firm, of course, does not have the same primary meaning as for lawyers, the principal other practitioners who are subject to rule 2(e). The lawyers' principal (though not exclusive) function with respect to practice before the Commission, so far as rule 2(e) is concerned, is in the representation of others in proceedings, formal or informal, before the Commission. Although accountants are also involved to some extent in representation of an informal sort, practice before the Commission in their case means principally the acceptance by the Commission of opinions which they have issued on financial statements.³⁴ Thus disbarment or suspension means in practice the refusal of the Commission to accept an opinion issued after audit by the accountant or firm concerned. The impact of this penalty is, where a firm is concerned, felt not merely by the firm but by its continuing clients, who may thereby be prevented from making filings on time, getting registration statements effective, and the like. It is, therefore, a rather blunt instrument; and the larger the accounting firm, the thicker is its edge, and the larger the number of clients that may be involved. Perhaps in part for this reason, the suspensions of large firms have been of limited duration.

Rule 2(e) in itself does not offer more flexible or discriminating sanctions; but the threat of that blunt instrument has been used to secure by means of consent a range of other remedies. These include effective suspension or disbarment of particular offices;³⁵ a prohibition on taking on new clients for a specified period;³⁶ and a requirement, parallel to that imposed by the court order upon LKH&H,³⁷ for adoption, compliance with, and submission to an inspection of a system of quality control.³⁸

C. *Sources of Particular Duties of Accountants*

The obligations of accountants under the federal securities laws are given shape and definition by pronouncements from three principal sources: the Commission, the profession, and the courts. The sources are not mutually exclusive; on the contrary, each draws on the others.

The Commission's pronouncements are principally in the form of either regulations, or interpretive releases—the latter being the more

³⁴ See rule 2(g) (2), 17 C.F.R. § 201-2(g) (2) (1973).

³⁵ See SEC Accounting Series Release No. 153 (Feb. 25, 1974).

³⁶ *Id.*

³⁷ In the LKH&H case, see note 30 *supra* and accompanying text, a Rule 2(e) consent order and judicial consent decree were combined evidently so as to provide a more comprehensive pattern of relief than would be available from either procedure by itself.

³⁸ See SEC Accounting Series Release No. 153 (Feb. 25, 1974).

numerous. Almost all of the releases deal either with the subject of independence, or with accounting presentation. On the former subject, there are both a regulation³⁹ and a series of releases⁴⁰ which in the aggregate set out a quite detailed set of rules for transgression of which the sanction may be either disqualification of the accountant or firm by refusal to accept its report in connection with a particular filing, or a sanction under rule 2(e). On accounting presentation there have also been a number of accounting series releases,⁴¹ although in this area the Commission has also paid considerable deference to pronouncements by the profession, through the Accounting Principles Board [APB], and has lately declared its intention to give similar deference to the pronouncements of the APB's successor, the Financial Accounting Standards Board.⁴² By rule the Commission has also issued quite detailed guidance as to the form of financial statements and schedules to be filed with the Commission.⁴³ In addition, the Commission has by rule prescribed in part the content of the auditor's report.⁴⁴

The one area in which the Commission has not issued pronouncements of general and binding effect is that of auditing. Indeed, the contrast between the extent to which the Commission has exercised authority in the fields of independence, accounting, and reporting on the one hand, and auditing on the other, is striking. In 1940 as a result of its study of the McKesson-Robbins affair, the Commission issued an amendment to its comprehensive Regulation S-X which prescribed that thenceforth auditor's reports to be acceptable for filing with the Commission must, *inter alia*, state whether the examination has been conducted in accordance with generally accepted auditing standards, and must describe any auditing procedures considered necessary in the circumstances which have been omitted.⁴⁵ As a result of the same investigation, the Commission also concluded that two auditing procedures which at the time of the Mc-

³⁹ SEC Regulation S-X, rule 2.01, 17 C.F.R. § 210.2-01.

⁴⁰ See, e.g., SEC Accounting Series Release Nos. 126 (July 5, 1972); 81 (Dec. 11, 1958); 47 (Jan. 25, 1944).

⁴¹ See, e.g., SEC Accounting Series Release Nos. 132 (July 19, 1972); 102 (Dec. 7, 1965).

⁴² SEC Accounting Series Release No. 150 (Dec. 20, 1973).

⁴³ SEC, REGULATION S-X, 17 C.F.R. § 210 (1973).

⁴⁴ Rule 2.02 of SEC Regulation S-X, 17 C.F.R. 210.2-02, not only prescribes in certain respects the form of an auditor's report (as to such matters as dating and signing) but also requires that the report state whether the audit was made in accordance with generally accepted auditing standards and whether any auditing procedures generally recognized as normal or determined necessary by the accountant have been omitted; requires the expression of an opinion as to consistency of application or as to material changes therein; and requires identification of any matters to which the accountant takes exception.

⁴⁵ SEC Accounting Series Release No. 21 (Dec. 5, 1941).

Kesson-Robbins affair had been considered by the profession to be optional—namely, observation of the physical taking of inventory, and written confirmation with third parties of receivables—should be standard procedures; but the Commission did not adopt any rule so requiring. Instead, it recognized with approval that the organized profession itself had already taken the steps necessary to make these standard auditing procedures.⁴⁶ There is one instance where the Commission has issued very detailed rules with respect to conduct of an audit: this is in connection with its requirements for the audit of broker/dealers.⁴⁷ These requirements, however, do not apply directly to accountants; rather, they impose upon the broker/dealer an obligation to secure an audit which meets the detailed requirements. The requirements become an obligation of the auditor, of course, by reason of his contractual engagement with the broker/dealer to perform an audit that will satisfy the exigencies of the form.

Pronouncements by the profession itself, through the AICPA, also play an important role in defining accountants' duties under the federal securities laws. Virtually all of the authoritative guidance with respect to the conduct of audits is thus to be found in the series of Statements on Auditing Procedure, which have recently been codified and renamed Statements on Auditing Standards.⁴⁸ These pronouncements will normally be given deference not only by the SEC, as detailed above, but also by the courts.⁴⁹

⁴⁶ SEC Accounting Series Release No. 19 (Dec. 5, 1940). To be sure, the tone of this pronouncement suggests that the Commission believed that it would have had authority to impose its own requirement that these two audit procedures be performed if the organized profession had not already acted on the matter. In addition, the amendments to Rule 2-02 of Regulation S-X which were adopted in SEC's Accounting Series Release No. 21 included a paragraph dealing with the auditor's consideration of and reliance on the client's internal control. These provisions, which were subsequently omitted from Rule 2-02, SEC Accounting Series Release No. 70 (Dec. 20, 1950), amounted to direct (albeit limited) prescription of the scope and conduct of the audit.

Although the Commission has thus indicated its belief that it has some authority to prescribe auditing procedures, and has in limited degree exercised such authority, it is dubious that the Commission has any very extensive authority in this regard. The only sources of such authority would be the general provisions of § 19(a) of the Securities Act and § 23(a) of the Exchange Act, which, while they can be clearly read to grant authority to prescribe accounting presentation and (by way of defining the term "certificate") the form and content of acceptable auditor's reports, say no more about authority to prescribe the manner in which auditors do their work than they do about how lawyers, who also file professional opinions with the SEC, should do their work. Cf. ALI FEDERAL SECURITIES CODE § 1503(a) (Tentative Draft No. 3, 1974) and comments thereto.

⁴⁷ See SEC Form X-17A-5.

⁴⁸ SAS 1.

⁴⁹ See, e.g., *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643, 703 (S.D.N.Y. 1968); *Rhode Island Hospital Trust National Bank v. Swartz, Brezenoff, Yavner & Jacobs*, 455 F.2d 847, 852 (4th Cir. 1972).

The courts' own views of what the standards should be also furnish a part of the definition of accountants' responsibilities under the securities laws. A result of this is that the pronouncements and general understanding of the profession will not necessarily set the limits on accountants' duties. For example, in the *Continental Vending* case the court stated:

Generally accepted accounting principles instruct an accountant what to do in the usual case where he has no reason to doubt that the affairs of the corporation are being honestly conducted. Once he has reason to believe that this basic assumption is false . . . full disclosure must be the rule unless he has made sure that the wrong has been righted and procedures to avoid repetition have been established.⁵⁰

The courts, writing federal common law in this area, have also looked to ordinary common law.⁵¹

D. *The Exigence of the Accountants' Duties*

The rigor of the accountants' duties under the federal securities laws, and the reciprocal threshold of legal liability, vary according to the factual situation⁵² and the particular source of legal liabilities.⁵³ The pertinent scale has four stops: The first is a duty of reasonable care with attendant liability for negligence; the second is a duty of honest belief, grounds for belief, and minimal care with the attendant liability being for recklessness, gross negligence, or constructive fraud; the third is simple honesty, in the sense of a clean heart and empty mind with attendant liability for fraud; and the final stop on the scale is no duty at all and thus no liability.

The situation in which the accountant has issued an opinion as auditor is, as already noted, that in which the accountant's obligations, not only professional but also legal, are most demanding—but the exact degree of care required will vary according to the statutory provision involved. Regardless of that variable, honesty on the accountant's part is in all circumstances required. Lack of honesty, in connection with a material misstatement or omission in the financial statements to which his opinion pertains, can lead to exposure to criminal liability as well as civil liability under any of the otherwise applicable civil provisions.

Where § 11 of the Securities Act is applicable, the standard is reason-

⁵⁰ *United States v. Simon*, 425 F.2d 796, 806-807 (2d Cir. 1969), *cert denied*, 397 U.S. 1006 (1970).

⁵¹ *See, e.g., Fischer v. Kletz*, 256 F. Supp. 180 (S.D.N.Y. 1967) (the Yale Express case).

⁵² See part I A *supra*.

⁵³ See Part I C *supra*.

able care; that is, in the terms of the statute, "reasonable investigation" and "reasonable grounds to believe," as well as actual belief, are required.⁵⁴ Under rule 10b-5 the standard can fairly be said to be honest belief and some ground therefore, plus a minimal level of care. However, the question of care under rule 10b-5 has not yet been settled. The Second Circuit has made clear its view that liability of a person acting as an accountant ordinarily does (that is, not a participant in the transaction or dealing face to face with the plaintiff, and facing claims only for money damage relief) will ordinarily require a showing of something more than ordinary negligence.⁵⁵ Other circuits have expressed the view, at least in dictum, that negligence alone will suffice;⁵⁶ but no Courts of Appeals have squarely so held.⁵⁷ I think the Second Circuit has the sounder view of the matter.⁵⁸

The ALI's Federal Securities Code in its current draft form would largely settle the question otherwise, making negligence the general standard not only for offerings of securities (now covered by § 11) but for Exchange Act registration statements and Form 10-K filings (now covered by rule 10b-5) as well.⁵⁹

With respect to the second factual situation—that is, where the accountant is associated with unaudited financial statements which bear his name and his disclaimer of opinion—the accountant's only obligation under the federal securities laws is one of honesty, and consequently, his liability is only for actual fraud (that is, actual knowledge of error or omission). The accountant could incur such liability for fraud either on the basis of having prepared the financial statements, or on the basis that his ostensible association with them, by reason of his disclaimer, implies a representation that he is unaware of any error.⁶⁰

There is surely no good reason to believe that there is any third party liability for ordinary negligence with respect to unaudited financials under the securities laws. The principal statutory provision under which that is

⁵⁴ Securities Act § 11(b), 15 U.S.C. § 77k(b) (1970).

⁵⁵ See, e.g., *Shemtob v. Shearson, Hammill & Co.*, 448 F.2d 442, 445 (2d Cir. 1971).

⁵⁶ See, e.g., *Ellis v. Carter*, 291 F.2d 270, 274 (9th Cir. 1961) and *White v. Abrams*, CCH FED. SEC. L. REP. ¶ 94,457 (9th Cir. 1974); *Kohler v. Kohler*, 319 F.2d 634 (7th Cir. 1963); *Myzel v. Fields*, 386 F.2d 718 (8th Cir. 1967), cert. denied, 390 U.S. 951 (1968); *Stevens v. Vowell*, 343 F.2d 374 (10th Cir. 1965).

⁵⁷ See *BUCKLO, Scienter and Rule 10b-5*, 67 N.W. L. REV. 562 (1972); but cf. *Drake v. Thor Power Tool Co.*, 282 F. Supp. 94 (N.D. Ill. 1967).

⁵⁸ See the separate opinion of Judge Adams in *Kohn v. American Metal Climax*, 458 F.2d 255, 279-88 (3d Cir. 1972).

⁵⁹ ALI Federal Securities Code § 1403 Tentative Draft No. 2 (March 1973).

⁶⁰ See SAS 1, § 516.06.

the standard of fault, § 11 of the Securities Act, contemplates no liability whatever for an accountant with respect to unaudited financials.⁶¹

As to possible liability with respect to unaudited financials for something in between negligence and outright fraud, under rule 10b-5 the critical fact should be that the accountant does not represent, by reason of his "association" with the financial statements or his disclaimer of opinion thereon, that he has performed any procedures at all with respect to them, to which degrees of care might attach. "The certified public accountant has no responsibility to apply any auditing procedures to unaudited statements."⁶² There should therefore be no such liability.

Some caveats must be added to the foregoing discussion, for it appears that the Commission is at least contemplating imposing some greater degree of responsibility on accountants for unaudited financial statements filed with the Commission.⁶³ In addition, the AICPA's Auditing Standards Division has published an exposure draft of a Guide for Engagements of Certified Public Accountants to Prepare Unaudited Financial Statements, which among other things suggests that certain standard procedures should be applied by accountants in preparing or assisting the preparation of unaudited financial statements.⁶⁴ If certain procedures did become standard, and authoritatively declared to be such, there would of course be an implicit representation by an accountant associated with un-

⁶¹ An accountant does incur some responsibility under Securities Act § 11 with respect to the unaudited "stub period" financials covering a period subsequent to the date of the audited financials, which are included in the registration statement. This responsibility arises from the fact that in his capacity as an expert under § 11(b)(3)(B) he must show that after reasonable investigation he had reasonable grounds to believe that there were no material misstatements or omissions in the audited financial statements *at the time the registration statement became effective*. Thus there is a requirement of reasonable investigation covering the period between the date of the audited financials and the effective date of the registration statement. This investigation is commonly called an "S-1 review," and it requires among other things review of the unaudited financials. See SAS No. 1, § 710.08. The accountant's responsibility in this regard, however, goes not to the unaudited stub period financials as such, but only to an error or omission which they might bring to light in the audited financials.

Also in connection with Securities Act registration statements, the accountant is ordinarily requested to furnish a "comfort letter" to the underwriters, see SAS No. 1, § 630. The review underlying the comfort letter includes some limited review of the unaudited financial information contained in the prospectus. Inadequate performance by the accountant of this limited review might give rise to liability to the underwriters, and the standards of such liability might be negligence. Since the representations made in the comfort letter are made in connection with a purchase of securities by the underwriter, such liability might be predicated on rule 10b-5.

⁶² SAS 1 § 516.02. An accountant who has prepared or reviewed unaudited financial statements for the client might, of course, be liable to the client for negligence. Such liability, however, would rest on common law, not the federal securities laws.

⁶³ See Address by Ray Garrett, Jr. to AICPA, Oct. 16, 1973.

⁶⁴ AICPA, TASK FORCE ON UNAUDITED STATEMENTS OF THE AUDITING STANDARDS DIVISION, GUIDE FOR ENGAGEMENTS OF CERTIFIED PUBLIC ACCOUNTANTS TO PREPARE UNAUDITED FINANCIAL STATEMENTS (Exposure Draft, March 1974).

audited financial statements that he had performed such procedures; and a failure to perform them, or to perform them with appropriate care, could give rise to liability. Even though the formulation of the standard of care—reasonable care, slight care plus honest belief and grounds for belief, etc.—would then presumably be the same as that applicable to audited financials, the procedures required to be performed in order to meet that care would of course be much less elaborate.

As respects the third factual situation identified above—that is, in which the accountant has prepared financial information for his client, but did not prepare it for public presentation, so that when the information is disseminated by the client it carries no representation, express or implied, on the part of the accountant—it seems beyond serious question that no more than plain honesty is required of the accountant. Correspondingly, he will not be liable to third parties except for fraud.⁶⁵

II. WHISTLE-BLOWING

Let us, then, turn to the fourth of the situations identified above: in which the accountant is aware of errors or omissions in filings by his client with the Commission, or other improprieties or misconduct by the client or its officers, but these do not have any material effect on financial statements for which the accountant has responsibility, and the accountant has neither direct nor ostensible responsibility for them, but merely knowledge. Does the accountant in these circumstances have an obligation to convey that knowledge to others—in the present context, the Commission⁶⁶—and a consequent exposure to liability for failure to make such report?

It may be useful preliminarily to make clear some of the issues that are not raised by this question. Since, by definition, errors, commissions, or improprieties have no material effect on the financials which the accountant has audited, no question is raised as to the accountant's obligation to detect fraud in the course of his audit.⁶⁷ For the same reason, no question is raised as to the accountant's obligation to deal with facts that he discovers after issuing his opinion, but which existed at the time he issued it, and which have a material impact on the financial statements to which his opinion refers.⁶⁸ Nor, finally, is any issue raised with respect

⁶⁵ Cf. *Wessel v. Buhler*, 437 F.2d 279 (9th Cir. 1971).

⁶⁶ As a practical matter, if whistle-blowing is done by accountants, it will most likely be done to the Commission and not to the public at large, because (a) this is easier to do, (b) the Commission is better situated to take remedial measures if they are called for, and (c) if there is complaint by reason of an accountant's failure to blow, the source of that complaint is likely to be the Commission.

⁶⁷ SAS 1, § 110.05-.08.

⁶⁸ See *Fischer v. Kletz*, 265 F. Supp. 180 (S.D.N.Y. 1967); SAS 1, § 561.01-.10.

to the accountant's obligations concerning events occurring subsequent to the date of the financial statements to which his opinion relates, but prior to issuance or reissuance of his opinion which affect the financial statements on which he has opined.⁶⁹

It may also be useful to point out that as a practical matter, the question of whether or not to "blow the whistle" will not arise before the end of a chain of events which is likely in most cases to foreclose the question at an earlier point. If an accountant does become aware of a problem, even one relating to matters for which he is not directly responsible, he will of course bring it to the attention of his client. It is not, hopefully, unrealistic to think that in most instances a client made aware of a significant misstatement or omission will take appropriate steps to correct it, and similarly, if made aware of misconduct by an officer or employee, will take steps to cure it. In addition, the accountant will sometimes be making representations to others with respect to the area in which the problems arise, by way of a comfort letter. When this is so, he will presumably make reference to the problem in the comfort letter; and the recipient of that letter will take such action as is necessary to see to it that the matter is corrected.⁷⁰ It is only if others to whose attention the accountant brings the problem fail to act that the question whether the accountant himself should take action arises.

The Commission's position on the question is fairly clear. Its allegations in the NSMC complaint assert that the accountants involved, who had in three successive comfort letters brought material error in the interim financial statements to the attention not only of their client but of the board of directors, the other party to the transaction, and counsel for both parties, and had in the last of their letters explicitly suggested that the financial statement should be corrected, should, when none of the recipients acted, have themselves brought the matter to the attention of the Commission or the stockholders.⁷¹ What are the possible grounds for such an obligation? Certainly there is no statutory ground. The obligation in question could doubtless be imposed by statute; but this has not been done. Conceivably, this obligation might be imposed by regulation, although the statutory authority for such a regulation would be questionable. In any event, however, this has not been done, and certainly had not been done at the time of the events brought in question by the

⁶⁹ SAS 1, § 560-01-.09.

⁷⁰ This can reasonably be expected if the recipient of the comfort letter is an underwriter, and a public offering is involved. It should, however, be recognized that in the NSMC case the recipients of the comfort letters did *not* take action.

⁷¹ Complaint, SEC v. National Student Marketing Corp., Civ. No. 225-72 [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,913-17 (D.D.C. 1972).

NSMC complaint. Although there has been talk, from Commission sources, of a concept of "auditor of record" which presumably would entail some responsibility of accountants for the affairs of their clients generally,⁷² this concept has not been implemented by formal Commission action. The closest the Commission has come to imposing a whistle-blowing obligation by regulation is in Item 12 of Form 8-K, dealing with changes in auditors, which requires a statement by the registrant as to whether there were certain kinds of disagreements with the former auditor; and also requires that the registrant secure from the former auditor a letter covering the same subject, which must be filed with the Commission. The requirement applies, as a direct matter, to the registrant; but there is little doubt that the former auditor is effectively obliged to furnish the letter. This reporting requirement, of course, carries some potential for bringing to the Commission's attention improprieties that do not directly affect financial statements for which an accountant has taken formal responsibility.

An obligation to report certain kinds of misconduct might also conceivably be made a condition for practice before the Commission; but again this has not been done; and there is considerable room for doubt that under the present statutes it could be done.⁷³

The NSMC complaint asserts that the obligation in question is a "professional"⁷⁴ one. The reference here could be either to the recognized standards of the profession, which in the case of the accounting profession are in large degree to be found in formal pronouncements of the AICPA, or else to ethical standards, which also have been codified. If the former reference was intended, then presumably it points to what is now codified in the AICPA, Statement on Auditing Standards No. 1 § 561. It could hardly be clearer, however, that this provision of the professional literature applies only to audited financial statements, for which of course the auditor takes both actually and ostensibly a far greater degree of responsibility than is the case with unaudited financials.⁷⁵

⁷² See Address by A. A. Sommer, Jr., "The Four Musts Of Financial Reporting" (January 8, 1974).

⁷³ The Commission's Rules of Practice, including its rules with respect to qualification and disqualification of professionals to practice before it, have no statutory basis except the general Commission authority under § 19(a) of the Securities Act and § 23(a) of the Exchange Act. In addition, as to lawyers, there is a statute, P.L. 89-332, which provides that any member in good standing of the bar of any jurisdiction has a right to practice before any Federal agency: this, of course, hardly can be construed as a grant of authority to impose conditions upon the practice of lawyers.

⁷⁴ See note 71, *supra*.

⁷⁵ SAS 1, § 561.01 provides:

.01 The procedures described in this section should be followed by the auditor who, subsequent to the date of his report upon *audited financial statements*, be-

What, then, about the possibility of an ethical requirement? If it were lawyers, rather than accountants involved, then in certain circumstances there would indeed be an ethical requirement to report improper conduct by the client.⁷⁶ This obligation, however, applies to criminal conduct or fraud occurring in the course of the lawyer's representation of the client.⁷⁷ This appears to mean that the improper activity of which the lawyer has knowledge must have a considerable degree of gravity to it; and in addition, that the activity is closely related to the subject matter of the attorney-client relationship.

There is no comparable ethical provision with respect to accountants. This perhaps reflects the fact that the problem is not one which can be expected to arise with any significant frequency in the practice of accountants; and, more fundamentally, the fact that it is not part of the ordinary professional role of accountants, as it is of lawyers, to assist their clients in dealing with the consequences of their own improprieties. There is, of course, a difference between lawyers and accountants on the other side of the scale as well: the lawyer is, as an ethical matter, required to observe a high degree of loyalty to his client. The loyalty is not exclusive, but it is clearly his primary professional loyalty. The accountant has substantial obligations to his client also, but his prime role as independent auditor necessarily implies an independence of his client's interests for which there is no close parallel in the ethical framework of the bar.

Wherever the exact balance should be struck between the conflicting obligations to the public and to the client imposed upon accountants as a matter of professional ethics, however, there is no basis in the accountant's Code of Ethics for a whistle-blowing obligation.⁷⁸ The auditor's obligation to the public relates to the responsibility he takes for the

comes aware that facts may have existed at that date which might have affected his report had he then been aware of such facts. (emphasis supplied.)

⁷⁶ ABA CODE OF PROFESSIONAL RESPONSIBILITY, DISCIPLINARY RULE 7-102(B) (1) states:

(B) A lawyer who receives information clearly establishing that:

(1) His client has, in the course of the representation, perpetrated a fraud upon a person or tribunal shall promptly call upon his client to rectify the same, and if his client refuses or is unable to do so, he shall reveal the fraud to the affected person or tribunal.

⁷⁷ See also *Id.*, DISCIPLINARY RULE 4-101(c) (3) regarding planned future crimes.

⁷⁸ The principal source of ethical requirements is the AICPA's Code of Professional Ethics, adopted in restated form effective March 1, 1973. Most of the State Boards of Accountancy have also promulgated codes of ethics, whose jurisdictional scope is somewhat larger than that of the AICPA Code because they apply not only to CPA's who are not members of the AICPA but also to certain other classes of licensed practitioners. Almost all of these codes follow the model of the AICPA Code, either in its present form or in the form of previous versions of it. None of these codes contains any provision with respect to whistle-blowing.

financial statements of the client when he issues an opinion on them. He does not purport by that opinion, or by his continuing role as independent auditor, to vouch for the rectitude of the client in any field other than the financial one, or in that field with respect to anything other than the financial statements which bear his report. Moreover, he has a clear ethical obligation of confidence to his client.⁷⁹

No source of a whistle-blowing duty is to be found in any general duty of citizens to report crimes. Virtually any material error of non-disclosure affecting the securities market, persisted in willfully (as would presumptively be the case after the accountant had brought the matter to his client's attention, and the client had refused to take action on it), constitutes a felony. Concealing a felony, of course, is itself the crime of misprison, which is defined as follows:

Whoever, having knowledge of the actual commission of a felony cognizable by a court of the United States, conceals and does not as soon as possible make known the same to some judge or other person in civil or military authority under the United States, shall be fined not more than \$500 or imprisoned not more than three years, or both.⁸⁰

Although the phrase "conceals and does not as soon as possible make known" could well be read as requiring no more than a passive failure to report a crime, the courts have found in the statute a requirement that there be, in addition to knowledge and inaction, "some affirmative act of concealment."⁸¹

Thus if the question is asked whether an auditor has an obligation to report his corporate client's illegal contributions in the last presidential campaign to the Special Prosecutor's office, the answer, if the penalties to which the client is subject would not be financially material, is no.⁸² The answer, so far as criminal law, and citizens' duties, are concerned, should be the same with respect to a client's violations of the federal securities laws.

There is, finally, the possibility that a failure to blow the whistle

⁷⁹ AICPA, CODE OF PROFESSIONAL ETHICS, rule 301.

⁸⁰ 18 U.S.C. § 4 (1970).

⁸¹ *United States v. Doddano*, 432 F.2d 1119 (7th Cir. 1970), *cert. denied*, 402 U.S. 905 (1971).

⁸² The penalty for violation of 18 U.S.C. § 610 is, so far as the corporate miscreant is concerned, a fine of \$5,000—a sum which would hardly be financially material for any registrant subject to the Commission's jurisdiction. See, however, *Ash v. Cort*, No. 73-179, 3d Cir. May 8, 1974, BNA SECURITIES LAW AND REGULATION REPORTER, May 8, 1974, p. A-1, where the Court of Appeals for the Third Circuit held that violations of this provision may give rise to an implied stockholders derivative action. See also, Securities Act Release No. 5466, CCH FED. SEC. L. REP. § 79-699, publishing the views of the Commission's Division of Corporation Finance to the effect that both a conviction under 18 U.S.C. § 610 and a pending indictment or information thereunder should be disclosed in proxies and information statements, and on Form 10-K and Form 8-K.

would be found to constitute aiding and abetting of the client's misconduct, for purposes of civil liability in either a private damage action or an injunctive proceeding by the Commission. Aiding and abetting in a civil as in a criminal context should, however, require an affirmative act of assistance or concealment, and a mere failure to report or disclose should not give rise to liability.⁸³ If this is so, then naturally there is no duty to blow the whistle.

In *Brennan v. Midwestern Life Ins. Co.*,⁸⁴ however, liability *was* found to lie under rule 10b-5 against a life insurance company by reason of market manipulations involving its stock by a securities dealer who made a market in its stock. The insurance company was not itself accused of manipulative activities, but only of aiding and abetting the manipulations, by reason of its failure to report the activities to either the state securities commission or the SEC. The court held, in substance, that aiding and abetting could be found in that case from evidence that showed little more than inaction in the face of knowledge that the violations were continuing. There are significant grounds on which the situation of an auditor should be distinguished from that of the defendant in the *Brennan* case, including the interest of the defendant in its own stock, which was the subject of the manipulations, and the fact that an auditor has a professional obligation of confidence. The case does, however, carry a lesson for accountants as well as others: that it does not take much, in a case where an offense is continuing or repetitive, to support a finding of aiding and abetting a violation of law by another with whom one has a continuing relationship.

I conclude, therefore, that there is no legal obligation on an accountant to report to the Commission or other governmental authority his client's errors, omissions and misdeeds. I also conclude, however, that as a practical matter, it will often be safer, and more sensible, for the accountant to follow a course which is other than that which would be dictated by considerations of legal obligation alone. In some cases the best course may be not to tattle but simply to part company with the client. In others it may be advisable to persuade the client itself to disclose the problem, or consent to its disclosure.

Where the offense is completed and not likely to be repeated (corporate contributions to a federal election campaign seem apt examples these days), and gives no reason to suspect that the client is prone to illegality or dishonesty generally, there is little reason for the accountant to take action at all.

⁸³ See *Wessel v. Buhler*, 437 F.2d 279 (9th Cir. 1971).

⁸⁴ 450 F.2d 991 (7th Cir. 1971).

Where, on the other hand, the offense is of a continuing or repetitive kind, and the accountant cannot persuade the client to desist, there is a great deal to be said for the accountant simply terminating his relationship with the client. The unreliability—indeed, by hypothesis, obdurate willingness to persist in error—manifested by the client with regard to one matter for which the accountant does not have responsibility may well extend to other matters, for which he does. The longer the accountant continues his association with the client, moreover, the greater will be the risk of a pattern developing which will later be susceptible to construction as aiding and abetting the client's misconduct.

Finally, there will be situations where, though the accountant may not himself feel free to report on his client, he will have every reason to persuade the client itself to make disclosure or correction. One such reason is that, as a prudential matter, considerable weight should be given to the view of the Commission about whistle-blowing that is manifested in NSMC, regardless of the flimsiness of that position's legal underpinnings. After all, when and if the case is decided on the merits, the Commission may, contrary to reason, prove right; and until proven wrong it is obviously ready to sue.

The toughest problem is likely to be presented by discovery of a material error or omission in a current filing, which continues to influence the market and which, so long as it is uncorrected, amounts to a continuing offense. Here the need for disclosure is most acute; but so is the risk that disclosure will bring about serious consequences to the client. Though difficult in theory this is perhaps not quite so bad in practice, since if the error or omission is such as to give rise to a potential liability for the issuer, disclosure may have to be made in the next annual financial statements. The auditor's pointing this out to the client may well offer sufficient leverage to get the client to make the necessary correction or disclosure.